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Update on German tax legislation

Content

As the 19th legislative period is coming to an end, the German government and legislature finalized some key tax bills. Please see our *EY Global Tax Alert dated 25 May 2021 for more information*. Major bills entered into force as they were published in the German Federal Gazette: The ATAD Implementation Act (ATAD-UmsG) was published in the Federal Gazette on 30 June 2021. Note the retroactive application of the main new provisions on hybrid mismatches as well as the overhaul of the concept of exit taxation and tax valuation of assets entering the German jurisdiction ("Ent- und Verstrickung") from 1 January 2020. Other aspects of the bill, such as the tightening of exit taxation for emigrating individuals according to Section 6 of the German Foreign Tax Act or the reform of controlled foreign corporation (CFC) rules, are applicable from 1 January 2022. For full coverage of the ATAD Implementation Act, see the *EY Global Tax Alert dated 15 July 2021*.

Update on German tax legislation

The Act on the Modernization of Corporation Tax Law (KöMoG), a bill implementing a "check-the-box" system for entity classification for tax purposes, was also published on 30 June 2021. The new provisions will apply from 1 January 2022, but taxpayers who want to make use of the check-the-box system for the tax period of 2022 must file a respective application no later than November 2021.

Moreover, the Act to combat tax evasion and unfair tax competition (StAbwG) introduces several actions against businesses that have relationships with territories named on the EU blacklist. The actions include increased documentation requirements as well as a withholding obligation on payments into such territories, a limitation on the deduction of expenses or the denial of certain beneficial mechanisms such as the flat rate taxation of capital income and the participation exemption regime. The act was also published in the German Federal Gazette on 30 June 2021. Whereas some provisions are applicable from 1 January 2022, other rules will be applicable even later. Prior to the act entering into effect, the Federal Ministry of Finance and the Federal Ministry of the Economy must publish a decree on the designated harmful tax jurisdictions.

The Act on Modernization of Withholding Tax Relief and various additional topics (AbzStEntModG) was published in the Federal Gazette on 8 June 2021. It introduces a revision and modernization of withholding tax procedures with respect to income from capital investment (i.e., dividends and interest) and royalties in Germany. The bill also includes a comprehensive reform of the German anti treaty shopping rule in Section 50d (3) of the German Income Tax Act, which is now to be applied in all open cases. For details on the Government draft law, which was adopted without major amendments, see the *EY Global Tax Alert dated 20 January 2021*.

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The German Supply Chain Due Diligence Act

On 11 June 2021, the German legislator approved the Federal Act on Corporate Due Diligence Obligations in Supply Chains (Supply Chain Act).

The Supply Chain Act introduces binding regulations on corporate responsibility for human rights and environmental protection where environmental risks can lead to human rights violations. The new act will be effective as of 1 January 2023 for all companies with their headquarter or a branch in Germany and with more than 3,000 employees in Germany. With effect as of 1 January 2024, it will apply also to companies and branches with more than 1,000 employees.

The Supply Chain Act stipulates due diligence obligations which companies must exercise in their own business operations and within their supply chains. The new set of rules will oblige companies covered by the act to review their supply chains and to enact a supply chain related compliance management system. The new regulations require remediation measures and may trigger the need to terminate contracts with suppliers as a measure of last resort. Non-compliance with these obligations will be sanctioned with a fine of up to 2% of the annual revenue and the exclusion from public tender procedures for up to three years. The enforcement by workers' unions or non-governmental organizations will enable legal action on behalf of injured parties against companies violating their due diligence obligations under the Supply Chain Act. This will further increase the risk that infringements of the new rules will expose companies acting in Germany to litigation, financial and reputational risks.

The Supply Chain Act will require companies to establish supply chain related compliance management processes, including (i) the adoption of a policy statement by the management of a company, (ii) the conduction of a risk analysis to identify and to prioritize human rights and environmental risks, (iii) the establishment of a risk management system to continually monitor and prevent risks and to avoid breaches of human rights, (iv) the set-up of a grievance mechanism and (v) the documentation and publishing of annual reports.

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New restrictions for services provided by the auditor according to the FISG – a game changer for tax and valuation services in the German market?

On 20 May 2021, the German lower house (Bundestag) adopted the German Act to Strengthen Financial Market Integrity (Finanzmarktintegritätsstärkungsgesetz, "FISG"). The primary goal of the new law is to improve the current system sustainably and strengthen the confidence in the German financial market. The new law entered into force on 1 July 2021.

It will impact the services which the current auditor of an EU PIE audit client can offer and provide to its audit client. With the FISG, the previous rule of the German Commercial Code (HGB) which allowed the auditor to provide tax and valuation services to its EU PIE audit client is deleted without replacement. The statutory regulation with derogation applicable up to and including 30 June 2021 shall be applied for the last time to all statutory audits of financial statements for the fiscal year beginning before 1 January 2022.

The FISG revokes the member state derogation rights with respect to the provision of tax and valuation services to EU PIE audit clients previously exercised by Germany. Under the derogation in Germany, tax and valuation services (non-auditing services (NAS)) of the current auditor for its EU PIE audit clients were largely permissible. Due to the revocation of the derogation rights for its member states, the so-called "blacklist" pursuant to Article 5 (1) subsection 2 of EU Regulation No 537/20142 applies now in full without exception. Accordingly, from 1 January 2022 on, tax and valuation services in Germany will be amongst the NAS that are not permitted any more. No transition period is granted. For the application of the above-mentioned EU Regulation, the principle of territoriality applies - as before. According to this, the law of the country in which the company has its registered office which is to receive the tax or valuation service is to be applied. After the FISG abolishes the right to vote for (permissible) tax and valuation services, the original blacklist of the EU Regulation applies to EU PIE audit clients based in Germany and to all EU PIE audit client affiliates based in Germany, according to which tax and valuation services are not permitted anymore. It also applies to branches of an EU PIE audit client located in another country. For affiliated companies to such an EU PIE audit client (subsidiary) located in another country, the rules are a little different and would require a diligent analysis.

It is important to understand that tax and valuation services are permitted and are to be finalized until 31 December 2021 with no transition period. As of 1 January 2022, tax and valuation services by the current auditor are no longer permitted until the audit for the fiscal year 2021 has been completed. This is the case when the audit opinion has been issued, the working papers have been archived and the invoice has been issued. If this is the case, for example, on 15 March 2022, then the application of the EU Regulation will end on 15 March 2022. This effective date shall be determined by the responsible auditor in each case. In our case above: From 16 March 2022, tax and valuation services by the "old" auditor would then be permitted if that auditor rotated out and was replaced by another auditor. If not, NAS by that auditor would continue to not be permissible. The EU Regulation 537/2014 stipulates for the statutory auditor of the EU PIE audit client that Article 5 of the EU Regulation (list of prohibited NAS) must be complied with until the audit report/issuing of the audit opinion is completed. Accordingly, until the certification for the audit 2021 (of the EU PIE audit client), a blackout period for the current auditor exists in which no tax and valuation services (NAS) are permitted. During this period, tax and valuation services need to be provided by another advisor.

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Germany extends reporting obligations to the Transparency Register

On 1 August 2021, the new Transparency Register and Financial Information Act (Transparenzregister- und Finanzinformationsgesetz – "TraFinG") came into force. The TraFinG introduced material changes to the provisions on the German transparency register, which will result in new filing requirements for many German legal entities and registered partnerships.

Previously, legal entities whose ownership and control structure, and thus their beneficial owners, could be determined entirely from other registers (e.g. the commercial, association or company register) were deemed to have fulfilled the obligation to notify the beneficial owners pursuant to Section 20 para. 2 of the German Money Laundering Act (Geldwäschegesetz – "GwG"), so-called "notification fiction". Only legal entities with beneficial owners that cannot be identified from the aforementioned registers needed to be reported to the transparency register, mainly ownership and control structures involving foundations that have not yet been recorded in registers, foreign shareholders, voting agreements that deviate from the normal case, or equity investments that are not apparent from the registers, such as in the case of limited partnerships.

Although the definition of a beneficial owner remains basically unchanged (every natural person holding or controlling, directly or indirectly (via a controlled legal entity) more than 25% of the capital, more than 25% of the voting rights or exercising control in a comparable way qualifies as a beneficial owner), the TraFinG now provides for the German transparency register to be converted from a "catch-all" register to a full register. This is done by abolishing the notification fiction, so that all legal entities are now in principle obliged to positively notify their actual or fictitious beneficial owners for registration, regardless of whether the relevant information can be derived from the commercial register or other publicly accessible sources. Even listed companies and their subsidiaries will have to submit notifications to the Transparency Register in the future.

However, the TraFinG provides for transitional periods to file beneficial ownership information for the first time solely due to the cancellation of the notification fiction as follows:

- for stock corporations (Aktiengesellschaften), European stock corporations (Societas Europaea) and limited partnerships limited by shares (Kommanditgesellschaft auf Aktien) until 31 March 2022;
- for limited liability companies (Gesellschaft mit beschränkter Haftung), cooperatives (Genossenschaften), European cooperatives (Europäische Genossenschaften) or partnerships (Partnerschaften) until 30 June 2022; and
- for all other obliged legal entities and registered partnerships until 31 December 2022.

This gives the legal entities concerned at least a certain grace period to implement the new obligations. However, such transitional periods only apply to those entities that were not obliged to report under the previous legal situation due to the exceptions and reporting fictions. Newly established companies or companies that have not reported for other reasons so far will need to report without delay and may not rely on the transitional periods.

Further, it should be noted that, depending on the individual case, the identification of beneficial owners can be complex and therefore time consuming so that it is recommendable for legal entities not to wait until the new reporting obligations apply to them. Failure to meet the reporting obligations may result in substantial fines of up to EUR 100,000 for simple infringements and of up to EUR 1 million in case of serious, repeated or systematic infringements.

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Germany implements the European Sale of Goods Directive and the Digital Content and Services Directive

The corresponding laws will come into force on 1 January 2022 and apply to contracts concluded on or after 1 January 2022. The Sale of Goods Directive (EU) 2019/711 replaces the Consumer Goods Directive and aims to strengthen consumer protection and the laws on the sale shall be adapted to the advancing digitalization. The implementation of these two directives is probably the largest and most significant change to the German Civil Code since the reform of the law of obligations in 2002.

Key elements are the redefinition of the concept of freedom from material defects, the introduction of regulations for the provision of items with digital elements and several new regulations in the sale of consumer goods. In addition to extensive full harmonization within the EU, the main new feature is that the concept of material defects and the warranty rules now also specifically target goods with digital content.

In future, freedom from defects shall require both compliance with subjective and objective requirements. In addition, requirements for assembly and, in the case of goods with digital content, for installability and the limited possibilities to agree on deviations will be regulated. Additionally, among others, supplements to the claims for subsequent performance and subsequent amendments as regards the supplier's recourse as well as to consumer protection laws (extension of reversal of burden of proof, guarantee rules, limitations period etc.) are implemented.

By way of the implementation of the Digital Content and Service Directive (EU) 2019/770, the German legislator newly introduced rules for all kind of digital consumer contracts in the general part of the law of obligations.

With regard to digital content, sellers shall have an obligation to update goods with digital elements. Electronic products such as smartphones or tablets only function properly and securely if the software behind them is also up to date. Functionality and IT security are thus to be secured even after handover of the goods for as long as the purchaser can expect based on the nature and purpose of the item and taking into account the circumstances and nature of the contract. If a permanent provision of digital elements has been agreed, special supplementary regulations apply.

However, resellers of digital content (e.g. smart devices, such as the smartphone or even fitness trackers, as well as vehicles with built-in navigation software) are often not in a position to keep the corresponding operating systems up to date and are dependent on the cooperation of their suppliers. The Digital Content and Services Directive provides for recourse against the manufacturer for updating and also enables the reseller to raise the objection of subjective impossibility against the consumer's claims which releases from the obligation to update. This regulation therefore only strengthens consumer protection to a limited extent.

For (re-)sellers, both stationary and online, the implementation of the Directives means first of all an analysis of their current business practices. (Online) retailers should review their terms and conditions as to the numerous and extensive changes.

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German BMF extends application period for treaty-based exemption claims from extraterritorial IP taxation to mid-2022

On 14 July 2021, the German Ministry of Finance (BMF) published an update to the guidance issued on 11 February 2021 addressing the currently discussed nonresident taxation of royalty income and capital gains relating to rights solely because these rights are registered in a public German book or register (for background, see *EY Global Tax Alert dated 11 February 2021*).

The update essentially extends the cutoff date and filing deadline for the application of a retroactive exemption for "clearly" treaty-protected royalty payments and stipulates that this procedure is applicable for payments made until 30 June 2022 (before the updated guidance, the applicable cutoff date was 30 September 2021). Further, the deadline to file an application for exemption as the key requirement for this procedure has been pushed out to 30 June 2022 as well (the deadline was previously 31 December 2021). See the above mentioned EY Global Tax Alert for more background and details.

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Fundamental administrative guidance on transfer pricing in Germany published

On 14 July 2021, the Federal Ministry of Finance (BMF) published the "Administrative Principles on Transfer Pricing" addressing all topics in the area of transfer pricing. The guidance is not binding to taxpayers and courts, but indicates the standpoint of the tax authorities. Mainly, the letter brings together known regulations. The OECD Transfer Pricing Guidelines (TPGL) now formally become a major point of reference for the German tax authorities. Some aspects are controversial, in particular the timing of application, which is stated to be "all open cases". Reactions in literature, including those of EY, reject this timing because it is in conflict with higher-ranking timing rules.

Chapter I explains how the different income adjustment rules in Germany relate to each other. Further, it is stipulated that arm's length corrections might be undertaken not only to the transfer price, but also to the rationale and the further conditions of a transaction. Also, the broadening of the term "affiliated person" is addressed. Companies might be considered affiliates if they operate in an orchestrated network without capital participation.

The OECD DEMPE function and the risk control approaches are adopted. The German tax authorities commit to the OECD transfer pricing methods and comparability standards. Long-lasting losses are, as a general rule, considered a trigger for an income adjustment. The letter requires the rationale of entering into a transaction to be assessed beforehand. The arm's length pricing test seems to be required for the actual result (outcome testing approach). The latter is surprising as in the past Germany was in favor of the price-setting approach. Reactions in literature, including those of EY, reject the mandatory requirement of year-end adjustments.

Trademark royalty charges are only accepted for tax purposes if the trademarks are registered. For sales of branded products, the general assumption is that the transfer price includes the remuneration for the trademark so that a separate license fee charge would not be accepted. The letter addresses financing relationships. Chapter X of the OECD TPGL is referred to. A debt-capacity test will be required to examine whether the recipient needs the cash for supporting its business. Only then will the arrangement be qualified as loan, otherwise equity input.

For determining an arm's length interest rate for a loan, the tax authorities advocate a balanced consideration between stand-alone and group rating. If the financing company does not have the ability and authority to control or bear the risk, the remuneration will be limited to a risk-free return. Collateralization of loans is in principle considered to be at arm's length. In individual cases, non-collateralization might be accepted. Cash-pool leaders should principally be considered as service providers earning a cost-plus remuneration on their operating costs. Only in rare cases should they earn an interest margin.

For a more detailed analysis, please refer to the *EY Global Tax Alert dated 23 July 2021.*

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BMF comments for the first time on the individual income tax treatment of virtual currencies and tokens

The German Federal Ministry of Finance (BMF) issued its first statement on the individual income tax treatment of virtual currencies and tokens with its letter dated 17 June 2021 (draft status). So far, German tax authorities have not taken a clear view on this topic, which gained increased practical relevance over the last years.

From a tax point of view, it was always questionable to what extent the disposal of currencies or activities in the context of virtual currencies such as mining, lending etc. constitute commercial activities or are qualified as private asset management and whether a tax-free disposal is possible after a holding period of one / ten years.

The key aspects of the BMF letter are summarized in the following:

- The BMF applies general German tax principles to distinguish private asset management from commercial activities such as the criteria for commercial securities trading developed by German tax case law.
- Units of a virtual currency held as business assets are considered non-depreciable assets. Mining is generally classified as a commercial activity. However, the taxpayer can prove the opposite. Allocation and valuation are based on general (tax) accounting principles. Hidden reserves upon disposal must always be disclosed.
- Regarding virtual currencies held as private assets, the decisive factor is whether the currency is used as a source of income (e.g. for lending/staking). If this is the case, the minimum holding period for a tax-free disposal of the currency is extended to ten years (instead of one year). The holding period is generally determined according to the first-in, first-out method.
- The BMF states that the exchange of a virtual currency into another virtual currency or into a state currency such as the Euro is considered a (taxable) disposal. However, the minimum holding period applies if the currency is held as private asset.
- Staking and lending, if they do not qualify as commercial activities, lead to other (taxable) income.
- Further, the BMF comments on other activities in the context of virtual currencies such as ICO, Forks etc.

The BMF draft letter is a first attempt to provide clarity from a tax perspective in a field that has been poorly regulated so far. However, the draft raises criticism and numerous questions within interest groups and investors such as the extension of the holding period for currencies used for activities such as lending. It remains open to what extent the BMF will respond to these reactions in its final version and to what extent the upcoming federal elections will affect the guidelines of the BMF in the next years.

Investors should review whether they are obliged to correct their tax returns, especially if they have treated capital gains from disposals as tax-free so far.

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German tax authorities

Further extension of the mutual agreements with neighboring countries for cross-border employments

In the light of the COVID-19 pandemic, the German Federal Ministry of Finance (BMF) announced on 3 April 2020 its intention to agree on mutual agreements with exceptional rulings for cross border employees. In the end, respective mutual agreements with seven of Germany's neighboring countries were concluded. No agreements exist with Denmark and the Czech Republic. The respective agreements with Belgium, Austria, Switzerland, France, and the Netherlands have been extended by the contracting countries and continue to apply at least until 30 September 2021.

The main purpose of those mutual agreements is to avoid changes in the taxation right which only result from the fact that cross-border employees work from their home country instead of from their workplace in the other country due to COVID-19 measures. Without specific agreements, many tax regulations are linked to the place of work performance. If applicable, the article of the respective Double Tax Agreement (DTA) with regard to the taxation of salary income would mostly be decisive for the question which country has the taxation right for the salary income. Due to this DTA article, the salary portions for the home office working days need to be taxed in the employee's home country whereas salary portions for working days at the employer's place of business are normally to be taxed by the other contracting country. However, the mutual agreements explicitly rule that working days carried out from home due to the COVID-19 crisis can be deemed to have been spent in the contracting country in which the work was originally intended to be performed. Thus, if the employee had normally worked at the employer's place of business, the taxation right stays with the country of the employee's work location and does not change to the employee's home country.

Anyone who wishes to make use of this option must present an employer's certificate indicating the working days spent from home due to the pandemic. Furthermore, it must be proven that the other contracting country in fact taxes the salary for the respective working days. The mutual agreements show individual differences in the requirements and scope of application. Therefore, an individual assessment and reconciliation with the other contracting country is mandatory.

In addition, some of the mutual agreements include further arrangements, e.g. on the implications on the specific cross-border rulings of the DTAs (e.g. with France or Austria) or regarding the constitution of a permanent establishment when performing work activities in the home office. If a CEO is temporarily forced to work in a different country due to the pandemic, the company's treaty residency due to the DTA might change. If an employee with the right to sign contracts on behalf of the company works from the home office for a certain period of time, the employer might constitute a permanent establishment in the employee's home country. The consultation agreement with Austria for instance includes an additional ruling with reference to the OECD guidelines that home office activities caused by the COVID-19 pandemic will not create a permanent establishment of the employer in the employee's home country.

Due to the ongoing pandemic situation, the BMF recently announced further extensions for the agreements with the abovementioned countries until at least 30 September 2021.

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DTA with the UAE ends on 31 December 2021

On its website, the German Federal Ministry of Finance (BMF) announces that the current double taxation agreement (DTA), dated 1 July 2010, between Germany and the United Arab Emirates (UAE) will not be extended. The DTA expires on 31 December 2021 unless both contracting states agree to an extension. According to the statement on the website of the BMF, the UAE was informed at diplomatic level on 14 June 2021 that Germany does not intend to extend the DTA. In addition, the BMF states that recently concluded agreements between Germany and the UAE will allow for a continuation of the exchange of tax information, including the Common Reporting Standard (CRS) and the Country-by-Country Reporting (CbCR). However, it is currently unclear if and when a new DTA between Germany and the UAE will be concluded.

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BGH clarifies: Cum-ex transactions were illegal

In its ruling dated 28 July 2021 (case number 1 StR 519/20), the Federal Court of Justice (BGH) assessed the so-called cum-ex transactions as intentional tax evasion and thus illegal.

Cum-ex transactions are a specific form of share dealings around the dividend record date of a stock corporation. Investors and banks trade shares in a company with ("cum") and without ("ex") dividends, i.e. the investors' share in profits. Institutional investors are exempt from capital gains taxes due on sales and can claim these back from the state. In the context of cum-ex transactions, capital gains taxes are reclaimed several times as a refund even though they were actually paid only once.

The case decided by the BGH involved two British stock traders whom the regional court of Bonn sentenced to so-called suspended sentences (Bewährungsstrafen) in the first cum-ex proceedings to be decided by a court. The regional court had already ruled that the cum-ex deals organized by the two traders constituted criminal tax evasion. The traders appealed the decision to the BGH, which finally rejected the appeal.

In particular, the BGH did not accept the traders' argument that the cum-ex transactions were merely the exploitation of a legal loophole, but that they were not illegal and punishable.

In the opinion of the BGH, the cum-ex transactions effected were neither legal structuring models nor the mere exploitation of a legal loophole because the legal regulation was clear. The court clarified: "There was no loophole here".

Accordingly, the BGH also did not follow the traders' argument that economic ownership within the meaning of tax law had already been established by the short sale agreements, and that there had therefore been several economic owners who had a legal claim to reimbursement of the capital gains tax against the tax authorities. In the view of the BGH, a mere agreement with a short seller cannot, in principle, give rise to beneficial ownership on the part of the purchaser. As a result, the BGH ruled the transactions as intentional tax evasion.

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BFH rules on cross-border company split

The German Federal Tax Court (BFH) ruled that the case-law based principles of a "company split" ("Betriebsaufspaltung") have to be applied on cross border constellations. If a domestic corporation leases real estate to its foreign operating corporate subsidiary, the leasing is qualified as trading activity.

The decision dated 17 November 2020 (I R 72/16) of the first senate of the BFH covers an outbound constellation where a trust received a dividend from its corporate Dutch subsidiary (BV). Furthermore, the trust with legal seat and place of management in Germany owned real estate in the Netherlands. The real estate was leased to the BV and used by the BV for its trading operations in the Netherlands.

The tax privileged trust argued based on its status that the distribution was attributed to its fully tax-exempt asset management activities. However, the tax authorities – as well as the regional tax court - took the view that the leasing activities of the trust created a separate trading/business activity which would fall out of the scope of the tax privilege (i.e., being regularly taxed). As a corollary, the distribution would be subject to the 5% add-back for non-deductible expenses and, hence, trigger an effective taxation on the dividend income of about 1.5%.

The tax authorities as well as the regional tax court took the view that the leasing activities did not generate mere asset management income but rather trading income. This is based on the principles of a "company split". A "company split" is assumed in constellations where

- an entity leases a business-essential asset to a commercially operating entity (asset criterion) and
- a person or a group of persons can control the decisions of both (leasing and operating) entities (personal criterion).

The BFH confirmed the view taken by the tax authorities as well as the regional tax court, i.e. the principles of a "company split" were applied also in the cross-border constellation without any difference to their application in pure domestic constellations. This is worth mentioning because it was questioned whether the principles of a company split can be applied in the case at hand as such principles have mainly been developed to avoid an erosion of the German trade tax base. However, the re-qualification of the income category (trading rather than asset management) does not apply for double taxation treaty purposes. Consequently, the mere leasing of immovable property does not create a permanent establishment per se. Without a (foreign) permanent establishment, the dividend income cannot fall within the scope of (full) exemption for foreign business income provided by the double taxation treaty.

The decided question with regard to the taxation of the dividend received by a tax privileged trust was rather special. However, as a takeaway, the principles of a "company split" have also to be considered in a cross-border context – for outbound as well as inbound constellations. Effectively, the BFH also confirmed the so-called "no-PE" structures: Leasing income can be generated free of trade tax in inbound structures.

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BFH sees post-transfer contributee conversion as harmful "sale"

In a recent decision (I R 25/18 of 18 November 2020), the Federal Tax Court (BFH) had to decide on the following situation: Two individuals decided in 2007 to both contribute corporate shareholdings into a commonly owned GmbH holding company. The share contribution was elected to be carried out at historic cost for tax purposes, and hence without taxable gain realization. As such, it triggered a seven-year holding period for the shares for the holding GmbH, during which any sale/alienation of the contributed shares would have retroactively triggered gain realization for the initial share contributors. In 2008, the GmbH was converted into an OHG (German unlimited partnership), again applying for book value carry-over. The question came up whether this mere legal conversion constituted a harmful sale transaction and thus led to the taxation of the previous contributions. The BFH found this to be the case, arguing that from a tax perspective, a conversion of a corporation into a partnership was a deemed transfer, due to the partnership's tax transparency, and that moreover in the given case, the conversion led to a reallocation of built-in gains between the partners/original contributors. Thus, the conversion of the contributee GmbH one year after the share contribution led to the retroactive capital gain taxation for the contributors of their 2007 share contributions.

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BFH provides further details on the add-back of rental costs for trade tax purposes

Under German trade tax law, rental payments made for the use of movable or immovable assets are to be partially added back to the trade income to the extent they were initially deducted when determining the profit of the business for income tax purposes. In addition, an add-back requires that the asset rented would be part of the fictious fixed assets, assuming the tenant would be the owner of such asset.

On 12 November 2020 (case reference III R 38/17), the German Federal Tax Court (BFH) issued yet another decision on the add-back of rental costs for German trade tax purposes. In the specific case decided, a film production company rented locations and equipment such as costumes, props, and camera systems. In contrast to the view of the film production company, the tax office treated the rental costs as subject to add-back for trade tax purposes.

The taxpayer firstly argued that they were disadvantaged compared to those taxpayers who produce tangible assets and whose rental costs are not added back as their rental costs are capitalized in the tax balance sheet and consequently do not reduce the relevant profit in the first place. However, since the taxpayer produced an intangible asset (film), capitalization of the production costs (including rental costs) was disallowed for tax purposes and, hence, an add-back was possible in principle. This view was rejected by the court, which referred to the legislator's leeway in shaping the laws, which it had not exceeded.

As in its previous case law, the BFH then confirmed that the add-back requires a classification of the rented assets as fictitious fixed assets of the taxpayer. The BFH stated that a constant use of the asset speaks in favor of a classification as fictitious fixed assets, while sporadic use speaks against it.

The classification as fictious fixed asset needs to be performed for each single asset considering the asset's purpose for the business. According to the BFH, a distinction must be made in this regard as to whether an asset serves the permanent production of products and is, therefore, a fictitious asset. On this basis, the BFH viewed camera systems and production facilities as fictious fixed assets and the respective rental costs as subject to add-back. If, on the other hand, the use of the asset is consumed during the production, there is no fictitious fixed asset. Hence, shooting locations and equipment were not considered as fictitious fixed assets and respective rental costs as not subject to add-back.

In summary, taxpayers should carefully review as to whether rental costs were incurred for fictious fixed assets based the above outlined principles of the BFH decision on an asset-by-asset basis.

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No precedence of the so-called simplified capitalized earnings method in determining the fair market value of an unlisted corporation

For tax purposes, the determination of the fair market value of an unlisted corporation can be carried out according to an individual capitalized earnings value method (e.g. the valuation standard IDW S1, the DCF or multiplier-method) or according to the so-called simplified capitalized earnings value method ("vereinfachtes Ertragswertverfahren"). However, based on the wording of the law it is unclear how the simplified capitalized earnings method relates to other individualized capitalized earnings value-oriented valuation methods.

In the opinion of the Federal Tax Court (BFH, decision dated 2 December 2020, II R 5/19), a lower tax court (respectively the responsible tax office) is obliged to determine the share value of an unlisted corporation which has so far been determined inadequately according to an individual capitalized earnings value method correctly with clarification of the facts. Recourse to the simplified capitalized earnings value method as a catch-all method is not permitted.

In fact, for the determination of the fair market value of shares in an unlisted corporation, the taxpayer alone has the choice between an individual capitalized earnings value method and the application of the simplified capitalized earnings value method.

The decision should be considered in the initial decision which method shall be applied in the determination of the fair market value of an unlisted corporation.

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Permanent establishment without employees: German local tax court expresses doubts regarding German approach of asset allocation and regarding applicability of exit taxation

The local tax court of Saarland recently decided in a proceeding on interim legal protection. In the underlying case, the tax authorities applied for the first time the "Authorized OECD Approach" (AoA) to a permanent establishment (PE) with no personnel. This resulted in a re-allocation of assets to a foreign PE. According to the local tax court, there is reasonable doubt regarding the lawfulness of this approach. Furthermore, in the court's view the application of exit taxation in such a situation is doubtful as well. Therefore, the court held that the execution of a tax assessment is to be suspended (order dated 30 March 2021, case reference 1 V 1374/20).

In the case at hand, a Danish corporation operated since 2011 through a German partnership wind energy turbines on leased land in Germany without own employees for managing or operating the sites. For FY 2013, the tax authorities did not accept the loss declared in the tax return for the German company. Rather, the tax authorities assessed a gain based on the argument that in that year the assets of the KG were to be re-allocated to the Danish head office of the German PE. The tax authorities argued that according to the AoA implemented from 1 January 2013 onwards, assets are to be allocated according to the personnel functions exercised in a PE. Due to the absence of employees in the case at hand, this led in the tax authorities' view to an allocation of the KG's assets to the Danish head office for tax purposes, thus triggering exit taxation in Germany for these assets "transferred" abroad.

In its decision the court held that in the given case there was reasonable doubt whether in case of a PE without personnel assets are actually to be allocated to the head office. In particular, the court noted that it was doubtful whether the rule drafted to implement the AoA in German tax law was suitable to provide guidance on asset allocation decisions as it was implemented as a transfer pricing rule. Even if that was the case, the court noted that asset allocation according to the personnel functions leads to inappropriate results in the case of PEs without personnel as that rule triggered in a first step the assumption of a PE, but at the same time allocated the assets to the foreign head office. The court held that in such cases a deviation from the standard rule (i.e. the allocation of assets following the personnel function) was possible both under the OECD 2010 Report on the Attribution of Profits to Permanent Establishments and under a German Ministry of Finance guidance dated 17 December 2019.

Moreover, the court observed that reasonable doubt existed also with regard to the question whether exit tax can be applied in a case where the loss of Germany's taxing right was triggered by a governmental action such as an amendment of the law resulting in the re-allocation of an asset abroad (so-called "passive" exit). More generally, the court also expressed doubt whether it is in line with a taxpayer's constitutional rights if Germany taxes hidden reserves of an asset while these assets continue to be part of the business of the taxpayer and at the same time no increase of liquidity occurs. The court found that sufficient reasons were in favor of the suspension of the enforcement of the tax assessment and therefore followed the taxpayer's application.

The court's reasoning in its order dated 30 March 2021 against the re-allocation of the wind energy turbines may be applied also in other situations of PEs with no employees where the implementation of the AoA led to reallocation of assets, but also in cases where e.g. changes to double tax treaties lead to similar effects. The same is true for the arguments raised against exit taxation in the case of such passive exits and against exit taxation as such. However, it should be borne in mind that the court only recognized that doubts regarding the lawfulness of the tax assessment existed, however these doubts do not necessarily mean that the court thinks that the claimant is more likely to win than lose the case.

The tax authorities filed an objection against the order of the local tax court of Saarland. Hence, the case is now pending before the German Federal Tax Court (case reference: IV B 35/21). It remains to be seen whether the Federal Tax Court will share the court's view and whether the claimant will continue to prevail in the main proceedings.

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Release of the EU Fit for 55 Package depicts future framework for business in the EU

On 14 July 2021, the European Commission (the Commission) presented its "Fit for 55" legislative package (Fit for 55 or the package). Fit for 55 is a comprehensive step in overhauling European Union (EU) legislation to align it with its increased climate ambitions as stated in the European Green Deal (EGD). It consists of 13 interconnected legislative proposals, including revisions to existing laws and proposals of new legislation. The package is comprehensive and complex in nature and it is expected to impact virtually every industry. While months of negotiations between the 27 EU Member States and the European Parliament will follow, businesses can start to digest and analyse what the changes may mean for their operations and their sustainability transformation plans.

Fit for 55 contains 13 legislative proposals consisting of revisions to existing laws and new legislation. It is meant to align the laws to achieve emission reduction and transition to a greener economy. The package includes plans to: (i) combine the expansion of emissions trading to new sectors and a tightening of the existing EU Emissions Trading System (ETS); (ii) increase use of renewable energy; (iii) generate greater energy efficiency; (iv) promote a faster roll-out of low emission transport modes and the infrastructure and fuels to support them; (v) align taxation policies with the objectives of the EGD; (vi) introduce measures to prevent carbon leakage; and (vii) provide tools to preserve and grow the natural carbon sinks. For more information about the legislative proposals, please refer to the *EY Global Tax Alert dated 15 July 2021.*

A specific measure to prevent carbon leakage and provide a level playing field for producers of energy intensive products is the planned Carbon Border Adjustment Mechanism (CBAM). Our *EY Global Tax Alert dated 29 July 2021* provides a more detailed summary. For a detailed discussion by EY about CBAM, please refer to this *webcast recording*.

Due to economy-wide implications impacting all industries and consumers, Fit for 55 is expected to trigger months of negotiations between the 27 Member States and the European Parliament. Businesses of all industry sectors are encouraged to closely follow developments related to the adoption of the proposals and factor the impacts into their current operations and sustainability transformation plans. The legislative plans do not just impact businesses established in the EU or Germany. Producers and supply chains will be affected globally for goods covered by the CBAM regulation that are manufactured in countries outside the EU and subsequently sold to and imported into the EU.

Given that many measures target reduction of carbon emission and circular economy, energy intensive sectors and businesses using hydrocarbon products will be most affected (metals, oil & gas, chemicals, automotive, generation of electricity etc.). However, virtually every sector will be impacted by the Fit for 55 regulations covering manufacture, transportation, waste management, real estate, agriculture and so on.

EY has already been involved in client projects assessing the Fit for 55 impact and the resulting cost, respectively challenges to their competitive situation on the market that for some businesses the expected cost implications can negatively impact the mid- or long-term business case. Therefore, despite the fact that the regulations are still subject to political discussion and details will further develop, enterprises should start now to analyze the impact of the proposed regulations to facilitate their business planning, strategy and investment. Furthermore, there is still the possibility to contribute in the process of public hearing at the political and administrative level.

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EY publications

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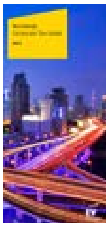
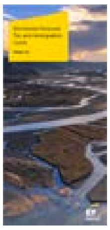


Worldwide corporate tax guide (2021 edition)
The worldwide corporate tax guide summarizes the corporate tax systems in more than 160 jurisdictions.



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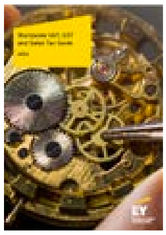

Worldwide VAT, GST and sales tax guide (2021 edition)
This guide summarizes indirect tax systems in 137 jurisdictions.

Upcoming EY events

The safety and wellbeing of our guests, EY people, and the local community are our primary concern. Given the unpredictable nature of the situation, EY will not host any physical events for the time being.

However, we are pleased to continue to offer webcasts on relevant issues under the following link:

www.ey.com/de_de/webcasts

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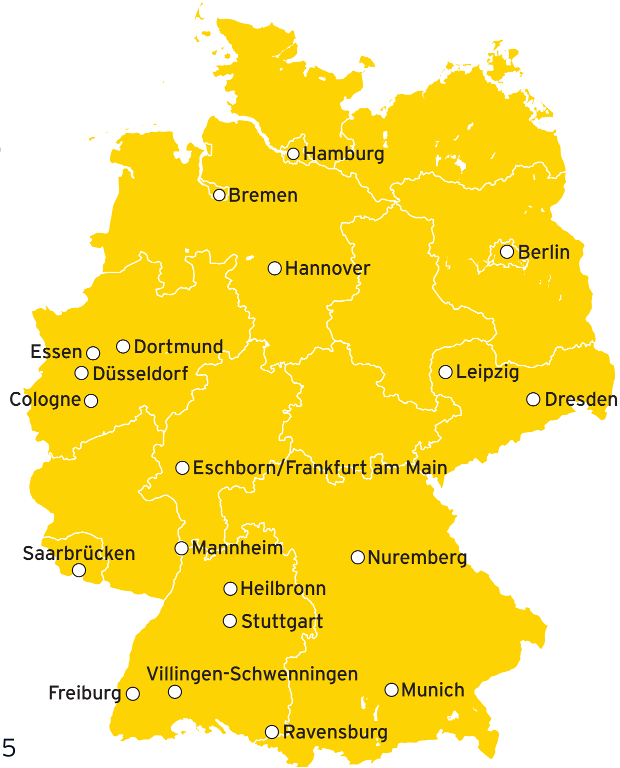

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